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IN THE

Supreme Court of the United States

OCTOBER TERM, 1954

No. 114

GENERAL AMERICAN INVESTORS COMPANY, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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Respondent in effect concedes that the Court below was right in saying that any attempt to dist. guish this case from *Commissioner* v. *Glenshaw Glass Company* and *Commissioner* v. *William Goldman Theatres, Inc.*, No. 199 this Term, on the ground that Section 16(b) speaks of "profit realized" and says it shall "inure to" the issuer, will not bear analysis. He expressly so concedes in his brief before this Court (pp. 30-32, footnotes 16 and 17) in those two cases to which he refers as presenting a "comparable issue", and he also so conceded in his brief before the Seventh Circuit in *Commissioner* v. *Obear-Nester Glass Company* (see footnote 2, p. 15, Pet'r Main Br.).

Respondent takes the broad position that every realized gain—by which he means every realized enrichment—is gross income within the meaning of Section 22(a) of the Internal Revenue Code and is taxable as income, except to

the extent *in haec verba* exempted by Congress (Resp. Br. pp. 8, 11-12, 17). If that be true, the potential reach of an income tax would extend far beyond anything heretofore conceived of. Realized gains or enrichments resulting from the receipt of unsought for bequests, inheritances, devises, gifts, contributions to capital, to say nothing of windfalls generally, all could be subjected to *income* tax if Congress so desired. Petitioner submits that this argument proves too much and is self defeating. For determining what is income there must be some criteria more in keeping with historical conceptions and common understanding in this country and elsewhere. These criteria are to be found in prior decisions of this Court, referred to in petitioner's main brief.

Apparently recognizing the weakness of his broad position that every realized gain or enrichment constitutes income, respondent argues (Resp. Br. pp. 15-17) that the receipts here "can be said to be derived from capital and labor" because (i) petitioner "received the payments in the lawful conduct of its business", (ii) "The payments derived from a lawful claim which constituted a property right" and (iii) "Collection of an obligation created by law would appear to be as much a business transaction as the collection of any other obligation". These propositions he supports by an assumption that the insiders availed themselves personally of confidential information belonging exclusively to petitioner and by the fact that petitioner expended legal fees, and therefore effort, in connection with the recovery. This reasoning has heretofore been considered of insufficient merit to justify serious consideration by any Court in any of the Section 16(b) cases, and petitioner submits it will no more bear analysis than the reasoning drawn from the statutory terms mentioned at the outset and now conceded to be unsound.

The income taxability of the recipient of a Section 16(b) payment depends on the true nature of the receipt. It

does not depend on whether the amount by which the insider is penalized is paid over (1) only after collection activities and the incurrence of recovery expense by the issuer or (2) without such activity or expense to the issuer either because paid over (i) voluntarily as required by law or (ii) as the result of activities or recovery expense incurred by the issuer's stockholders upon failure of the issuer to act. A purely donative promise is enforceable in New York (see *Preston* v. *Commissioner*, 132 F. 2d 763 (2d Cir. 1942)); but a gift does not cease to be a gift and become taxable income merely because the promisee finds it necessary to hire a lawyer at the cost of $13,000 to enforce the donative promise. Here the receipts had their origin in the statute and not in the mechanical steps taken for recovery. And of course they had nothing to do with and were not sought for in the conduct of the issuer's business. They are wholly unlike extorted money which has its only origin in activities deliberately undertaken to obtain it.

The real essence of respondent's argument is that a Section 16(b) payment is income to the issuer because derived from a corporate property right consisting of confidential inside information used by the insider. But the assumptions underlying this argument are legally and factually incorrect. It cannot reasonably be assumed, as respondent suggests, that every insider—including every 10% stockholder however inactive he may be—"automatically obtains" inside confidential information "by virtue of his position". Section 16(b) liability is not based on the actual use of inside information but arises whether or not inside information is used. The penalty is imposed even though it is definitely proved that no inside information had in fact been available to or used by the insider. It is imposed even though the insider—or, as might happen, a lender holding his stock as collateral—disregarded any inside information and actually acted contrary to the manner in which intelligent use of it would have indicated. No theory of trustee's accountability can be applied, for

there is no trust *res*. The article from which respondent quotes (Resp. Br. p. 16) fully recognizes this.[1] Section 16(b) is a policy measure designed to be preventative in the situations covered.[2] The purpose was not to create income for the issuer from the use of inside information but to stop insiders from possible misuse of such information. The liability, as pointed out in petitioner's main brief, has been uniformly held to be penal.

In the present case there is every indication that the so-called insider's profit was derived not from inside information but from appreciation in value of stock purchase warrants brought about by appreciation in value of the stock subject to the warrants while the warrants were outstanding. Though there was no short swing trading in any economic sense, the statute technically applied since, ignoring the ownership and increase in value of the warrants, the statute treated the exercise of the warrants simply as a purchase, and compared the purchase price as computed with the proceeds received from contemporaneous stock sales.

Petitioner sees no occasion to enter into the historical discussion of direct taxes versus indirect taxes for Constitutional purposes, with which respondent deals in his brief before this Court in the *Glenshaw Glass* and *William Goldman Theatres* cases. In *Pollock* v. *Farmers' Loan and Trust Company*, 157 U. S. 429 (1895), 158 U. S. 601 (1895), and *Brushaber* v. *Union Pacific Railroad Company*, 240 U. S. 1 (1916), to which respondent there refers, this Court

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1. In the very paragraph from which his quotation is taken (Cook and Feldman, *Insider Trading under the Securities Exchange Act*, 66 Harv. L. Rev. 385, 408 (1953)), it is said: "Unlike the 'corporate opportunity' cases, however, the action may be brought even though the insider has not competed with his corporation in the use of the information"; and two pages later (p. 410) it is said: "the persons liable under the section and the measure of liability are both based upon arbitrary rules of thumb, independent of any proof of actual use of confidential information."

2. The statute does not cover purchase and sale or sale and purchase transactions where the elapsed time between them exceeds six months, nor does it cover transactions by persons other than the insiders themselves irrespective of whether inside information was turned over and used in such cases.

spoke only of income from real and personal property and from professions, trades, employments and vocations. There was no suggestion in those cases that other kinds of enrichments constituted income or, if not, that a tax thereon would not be a direct tax in the Constitutional sense. The question here is whether or not the receipts in question were intended to be, and are by their nature, income within the statutory definition of gross income. If Congress intended to tax the receipts as income to petitioner and they are income to petitioner, then they are subject to the income tax respondent seeks to impose; if Congress did not intend to tax them as income to petitioner or if they cannot be treated as income to petitioner, then they are not subject to the tax.

In pressing its case, petitioner urges this Court to bear in mind that the question of Congressional intent here involved is not one of exemption from taxation but one of double taxation. Respondent's position really is that any profit realized by the insider, taxed once to him, should be taxed a second time when upon command of the statute it is paid over to the issuer. Indeed, in many cases the combined taxes would exceed 100% of the profit. Petitioner insists Congress did not intend such double taxation when, as a matter of public policy, it chose to deter the insider by directing him to disgorge to the issuer rather than to some other recipient, whether it be the public treasury or a public charity.

Respectfully submitted,

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February, 1955

MEMORANDUM FOR THE RESPONDENT

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MEMORANDUM FOR THE RESPONDENT

SIMON E. SOBELOFF,
Solicitor General,
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The Commissioner does not oppose the granting of a writ of certiorari in this case, although he believes that the decision of the court below is correct.

The question involved is whether the profits of insiders derived from short-term trading in the taxpayer's stock which were recovered by the taxpayer under Section 30 (f) of the Investment Company Act of 1940, c. 686, 54 Stat. 789 (15 U. S. C. 80a-29 (f)), and Section 16 of the Securities Exchange Act of 1934, c. 404, 48 Stat. 881 (15 U. S. C. 78p), constitute income to the

taxpayer under Section 22 (a) of the Internal Revenue Code (26 U. S. C. 22). The court below held that such profits are income within the meaning of Section 22 (a) of the Code, and relied upon the decision of the Court of Claims in *Park & Tilford Distillers Corp.* v. *United States*, 107 F. Supp. 941, involving substantially similar facts, in which this Court denied certiorari, 345 U. S. 917.

The taxpayer alleges that the decision below is in conflict with the recent decisions of the Third Circuit in *Commissioner* v. *Glenshaw Glass Co.* and *Commissioner* v. *Goldman Theatres, Inc.*, both reported in 211 F. 2d 928, in which it was held that punitive damages recovered for fraud and under the antitrust laws do not constitute income under Section 22 (a) of the Code. (Pet. 6–13.) In those cases the Third Circuit adhered to its prior decision in *Central R. Co.* v. *Commissioner*, 79 F. 2d 697, in which it had held that property received in settlement of a suit, stated to constitute a "penalty" to the payor and a "windfall" to the taxpayer-payee, did not constitute taxable income. The *Glenshaw Glass Co.* and *Goldman Theatres, Inc.*, cases are now before this Court on a petition for a writ of certiorari, No. 199, and one of the reasons assigned for granting the writ was that those decisions differ, in their interpretation of the holdings of this Court, with the decision of the

Second Circuit in this case.[1] Therefore, while we believe that the decision of the court below is correct, the Government does not oppose the granting of the writ.

SIMON E. SOBELOFF,
Solicitor General.

JULY 1954.

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[1] In opposing certiorari in *Park & Tilford*, the Government did not deny the alleged conflict with *Central R. Co.* v. *Commissioner*, but suggested that it was wrongly decided and might not be followed.